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IN THE

Supreme Court of the United States

OCTOBER TERM, 1946

No. 998

ST. REGIS PAPER COMPANY,
Petitioner,

against

JOSEPH T. HIGGINS, Collector of Internal Revenue,
Respondent.

PETITION FOR WRIT OF CERTIORARI

HORACE R. LAMB,
Counsel for Petitioner,
15 Broad Street,
New York, N. Y.

Dated, February 3, 1947.

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To the Honorable the Chief Justice and the Associate Justices of the Supreme Court of the United States:

Petitioner respectfully shows:

Jurisdiction

The judgment of the Circuit Court of Appeals below was entered November 8, 1946. The jurisdiction of this Court is invoked under Section 240(a), Judicial Code, 26 Stat. 828, as amended by the Act of February 13, 1925, 43 Stat. 938.

Opinions Below

The opinion of the Circuit Court of Appeals affirming the decision of the District Court, is reported at 157 F. (2d)

884. The opinion of the District Court (R. 250) is unreported.

Statutes Involved

The pertinent statutory provisions are Section 14(b) and Section 22(a) of the Revenue Act of 1936, 49 Stat. 1655, 1657, which read in part as follows:

> "Sec. 14. SURTAX ON UNDISTRIBUTED PROFITS.
>
> * * * *
>
> (b) Imposition of Tax.—There shall be levied, collected, and paid for each taxable year upon the net income of every corporation a surtax equal to the sum of the following, * * *.
>
> "Sec. 22. GROSS INCOME.
>
> (a) General Definition.—'Gross income' includes gains, profits, and income derived from * * * dividends * * *."

Summary Statement of the Matter Involved

This is a civil suit for refund of $54,325 representing surtax on undistributed profits paid by petitioner for the calendar years 1936 and 1937.

In 1929 petitioner, a New York corporation, acquired substantially all the assets of Bates Valve Bag Corporation, a Delaware corporation (R. 214-218). Thereupon petitioner caused a new corporation, also called Bates Valve Bag Corporation, to be organized under the laws of the State of New Jersey and the assets, subject to liabilities of the Delaware corporation, were conveyed by petitioner to the New Jersey corporation in exchange for all the issued shares of the capital stock of the New Jer-

sey corporation, which then became a wholly-owned subsidiary of petitioner (R. 240).

On December 24, 1936 the Board of Directors of the subsidiary declared and the subsidiary thereafter paid to petitioner a purported dividend of $150,000; on December 14, 1937 the subsidiary's Board of Directors declared and the subsidiary thereafter paid to petitioner a further purported dividend of $115,000 (R. 223-224, 229-230). In petitioner's income tax returns filed with respondent for the calendar years 1936 and 1937, petitioner included the foregoing amounts, respectively, in its gross income.

At the time each of the said amounts was paid to petitioner, both petitioner and its wholly-owned subsidiary were subject to restrictions on payment of dividends contained in an Indenture dated August 1, 1927, originally executed by the Delaware corporation and providing for an issue of debentures by that corporation. The obligation for the payment of the debentures was expressly assumed in 1929, first by petitioner at the time of the original acquisition by petitioner of the assets of the Delaware corporation, and secondly by petitioner's subsidiary at the time of the transfer of the assets to the subsidiary (R. 215-222). The Indenture was in effect as a valid and subsisting contract and the debentures issued thereunder were outstanding throughout the calendar years 1936 and 1937.

The Indenture of August 1, 1927 included an express provision restricting payment of dividends, as follows (R. 210-212):

> "ARTICLE FOUR
>
> "Section 13. So long as any of the Debentures are outstanding the Company will not declare or pay or set aside any dividends on its capital stock,

other than dividends payable in stock of the Company, or make any distribution of capital on any class of stock, or purchase or redeem any class of stock, except out of surplus earned by the Company; and in no event will it pay any cash dividend, or make any distribution of capital on any class of stock, or purchase or redeem any class of stock if such payment, distribution, purchase or redemption would reduce current assets of the Company (as hereinafter defined) to less than two hundred per cent. (200%) of current liabilities, or would reduce the assets of the Company exclusive of good will and patents and patent rights, after deducting all liabilities other than funded debt, to less than twice the amount of the funded debt. * * *"

In 1938 Continental Illinois Bank and Trust Company, Chicago, Illinois, the Trustee under the Indenture, notified petitioner's subsidiary that the purported payments of dividends in 1936 and 1937 were made in violation of Article Four, Section 13 of the Indenture above quoted (R. 235). The subsidiary's Board of Directors considered such notice and on December 14, 1938 rescinded its previous resolutions declaring dividends (R. 242). Thereafter, petitioner on December 15, 1938 (R. 240-242) made repayment to Bates of the said amounts of $150,000 and $115,000, respectively (R. 244).[1]

At the time the payments were made in December 1936 and in December 1937 and throughout 1938, with one

1. Bates Valve Bag Corporation filed suit for refund claiming credit, under Section 26(c)(1) of the Revenue Act of 1936, against surtax on undistributed profits because of the prohibition against payment of dividends contained in Article Four, Section 13 of the Indenture. The Circuit Court of Appeals below reversed a judgment of the District Court in favor of the corporation on the ground that it could have declared dividends payable in its own unsecured obligations. *Bates Valve Bag Corporation* v. *Higgins*, 157 F. (2d) 886, decided November 8, 1946.

exception, the same individuals who were members of the Board of Directors of the subsidiary were also members of the Board of Directors of petitioner. The same situation existed with respect to officers of Bates; with the exception of one officer of the subsidiary, all of the subsidiary's officers were officers of petitioner (R. 225-240).

On January 12, 1939 petitioner filed timely claims with respondent for refund of $54,325. The present action was timely begun on February 25, 1941.

The Question Presented

Did the gross income of petitioner for each of the calendar years 1936 and 1937 properly include the purported dividends paid to it by its wholly-owned subsidiary in violation of the express provision of a contract binding on both petitioner and subsidiary and which purported dividends were repaid to the subsidiary in 1938?

The answer to the foregoing question depends upon (1) whether, when received by petitioner, the purported dividend payments were impressed with a constructive trust in favor of the subsidiary and its creditors, or (2) whether the payments were received by petitioner under a "claim of right".

Reasons for Granting the Writ

I

In the decision below the Circuit Court of Appeals for the Second Circuit has decided an important question relating to corporation federal income tax liability in direct conflict with the decision of the Circuit Court of

Appeals for the Sixth Circuit in *Knight Newspapers, Inc.* v. *Commissioner*, 143 F. (2d) 1007 (1944).

In the *Knight* case, the taxpayer owned all of the outstanding common stock of a publishing company which published a daily newspaper in Miami, Florida. The preferred stock of the publishing company was held by others. On December 30, 1939 the directors of the publishing company declared a dividend on the common stock for 1939 and credited it on the books of that company on an account then owing by the taxpayer to the publishing company. The publishing company reported the dividends as paid and the taxpayer reported the dividends as accrued income.

The publishing company's outstanding preferred stock included a preferential provision restricting dividends on common stock only if, following payment of such dividend, current assets exceeded current liabilities by $65,000. On December 2, 1940 the directors of the publishing company decided that on December 30, 1939 the company did not have sufficient surplus to satisfy the aforementioned restriction. Consequently, the board adopted a resolution declaring the 1939 dividend illegal and void, repealing and rescinding the dividend and directing the officers to cancel the credit given to the taxpayer. The credit was cancelled and the taxpayer recharged the publishing company in an amount equal to the dividend which was rescinded.

The Tax Court held that the taxpayer had received taxable income in 1939. On appeal, however, the Circuit Court ordered the case remanded to the Tax Court for further proceedings so that proper proof could be received with respect to the ratio of assets to liabilities at the time of the declaration of the dividends. In the course of its

opinion the Circuit Court indicated that the taxpayer had not received any income as a result of the declaration of the dividend in violation of rights of preferred stockholders because of the existence of a constructive trust.

By parity of reasoning petitioner contends here that, as in the *Knight* case, there was a constructive trust with respect to the 1936 and 1937 purported dividend payments received by petitioner from its wholly-owned subsidiary. The constructive trust arises because (1) petitioner had actual knowledge of the provisions of the Indenture restricting payment of dividends, (2) petitioner dominated the management of its wholly-owned subsidiary and (3) the retention of the payments by petitioner would have prejudiced the rights of the subsidiary's debenture holders. Furthermore under Section 2 of Article 11 of the 1927 Indenture, the payments in violation of the express prohibition against cash dividends constituted a default which, if not cured by the rescission and return of the payments, would have permitted the trustee to declare due and payable the entire issue of debentures then outstanding.

Rejecting petitioner's contention, the Circuit Court of Appeals below referred to the *Knight Newspapers* case as follows:

> "• • • Unless *Knight Newspapers* v. *Commissioner*, 6 Cir., 143 F. 2d 1007 is distinguishable on the facts because that case involved only book entries and not the actual payment and receipt of dividends *what we have decided is contrary to it.* To the extent that it may be, we now, with deference, follow our own prior decision in the *City Bank* case." (Italics ours.)

A careful reading of the opinion in the *Knight Newspapers* case clearly shows that the Circuit Court of Appeals did not rest its decision either wholly or substantially on the fact that there was no physical payment nor physical receipt of dividends. The fact is that the taxpayer had actually received the dividend by way of a credit against the debt which it owed to the company issuing the dividend. That the wrongful dividend was received as a credit against a debt rather than as a cash payment is, we submit, a fact of no consequence.

There is, therefore, a clear conflict between the decision in the *Knight* case, decided by the Sixth Circuit Court, and the decision of the Second Circuit Court below. In its statement regarding the *Knight Newspapers* case, the Circuit Court below has plainly recognized the existence of the conflict.

II

In the decision below the Circuit Court of Appeals for the Second Circuit has decided an important question of federal income tax liability which is probably in conflict with the decision of this Court in *Commissioner* v. *Wilcox,* 327 U. S. 404 (1946).

In the *Wilcox* case this Court held that a taxpayer who, in violation of the criminal laws of the State of Nevada, had taken money which belonged to another person did not realize income for federal income tax purposes on the receipt of such money. This Court emphasized the fact that the taxpayer had no title to the money and that he was under an unqualified duty and obligation to repay it to his employer. Even if he had not been guilty of a crime, Wilcox would still have been

guilty of a tort, would have had no legal title to the money and thus would have been obligated to return it as a tort-feasor.

Here petitioner's rights to the purported dividend payments were clearly subject to a constructive trust for the benefit of the subsidiary and its creditors. In the circumstances, the declarations of the purported dividends created no valid debts due petitioner. Thus petitioner had no valid right to retain the amounts received. In equity the Trustee under the Indenture could have followed the payments in the hands of petitioner. Plainly, the moneys were received by petitioner subject to a duty to return it to the subsidiary. Therefore, here, as in the *Wilcox* case, the taxpayer did not receive and could not have received the moneys under any so-called "claim of right". Even if Wilcox had believed that he was entitled to the money, the receipt thereof would not have constituted income. Similarly, here petitioner's receipt of the purported dividends cannot be taxable income as of the time of receipt.

III

The Circuit Court of Appeals for the Second Circuit has decided an important federal tax question in direct conflict with decisions of the Court of Claims of the United States.

In *Harold D. Greenwald* v. *United States,* 57 F. Supp. 569 (1944), the taxpayer, as a corporate officer, had received bonuses based on profits determined by independent accountants and had included such bonuses in gross income during the years of receipt. Several years later his corporate employer discovered that the profits on which the bonuses had been declared had been

intentionally exaggerated by such accountants without any fault of the taxpayer. Upon such discovery taxpayer repaid to his employer the excess bonuses.

Taxpayer then filed claims for refund for the years of receipt. The Court of Claims sustained the taxpayer's contention that he was entitled to refund of the income taxes paid on the excess bonuses included in gross income.

Similarly, in *Arthur H. Weils et ux.* v. *U. S.*, 64 F. Supp. 476 (1946), the Court of Claims held that certain compensation was not includible in gross income under the following circumstances. The taxpayer was entitled, under an employment contract, to a certain percentage of the net profits on completed construction work. In advance of a computation of net profits for 1934, he was paid $45,000 in that year which he included in gross income. Two years later it was determined that he had been overpaid because net profits turned out to be less than expected. He returned the amount of the overpayments. The Court of Claims held that the taxpayer was not entitled to any deductions for the years of repayment but that he was entitled to a refund for 1934 on the over-statement of his percentage of the net profits.

The decisions of the Court of Claims in the *Greenwald* and *Wells* cases are irreconcilably in conflict with the decision of the Circuit Court below. In the interest of clarity, that conflict should be resolved by this Court.

IV

The Circuit Court of Appeals for the Second Circuit has decided an important question in the administration of the federal income tax law relating to the scope of the so-called "claim of right" theory as applied to receipt

of income which should be clarified and re-stated by a decision of this Court.

The Circuit Court below relied chiefly on its decision in *National City Bank of New York* v. *Helvering,* 98 F. (2d) 93 (1938), notwithstanding the fact that that case is, or at least should be, of historic interest only in the light of this Court's decision in *Commissioner* v. *Wilcox, supra.* The *National City Bank* case, in turn, relied on the decision of this Court in *North American Oil Consolidated* v. *Burnet,* 286 U. S. 417 (1932).

The Circuit Court of Appeals for the Sixth Circuit, in *Knight Newspapers, Inc.* v. *Commissioner, supra,* and the Court of Claims in *Greenwald* v. *U. S.* and *Wells* v. *U. S., supra,* distinguished the decision of this Court in the *North American Oil Consolidated* case. The Circuit Court below refused, however, to follow the views taken by the Circuit Court for the Sixth Circuit and by the Court of Claims, and took the position that the *North American Oil Consolidated* case decision controlled here.

It is needless to labor the point before this Court as to the importance of a clear understanding of what the so-called "claim of right" doctrine really is. Although this Court in *Commissioner* v. *Wilcox, supra,* did not overrule *North American Oil Consolidated* v. *Burnet, supra,* it did in fact place substantial limitations upon the scope of that case. It would appear, therefore, that "claim of right" is no longer the all-inclusive concept it may have been prior to *Commissioner* v. *Wilcox.*

We respectfully submit that the instant case presents an excellent opportunity for this Court, in the exercise of its discretionary powers, not only to correct the error in the decision below, but to re-state its views on the subject of "claim of right" as applied to the taxability

of the receipt of money for income tax purposes. If the rationale of *Commissioner* v. *Wilcox, supra,* is applicable only to factual situations involving criminal violations, the various lower Federal Courts and taxpayers generally would be benefited by a decision of this Court. Likewise, if the scope of *Commissioner* v. *Wilcox, supra,* is broader than the Circuit Court below has indicated, then the courts and taxpayers generally should be guided by a decision of this Court.

For the reasons stated herein, your petitioner respectfully prays that a Writ of Certiorari to the Circuit Court of Appeals for the Second Circuit be granted.

Respectfully submitted,

HORACE R. LAMB,
Counsel for Petitioner.

Dated: February 3, 1947.